Private governance and the shadow of the state

coffee

I went to a lunch at the Legatum Institute yesterday to hear Ed Stringham talk about private governance. Ed's argument is that many of the transactions that take place in today's economy happen without the involvement of the state to keep people playing by the rules. Things like reputation are a much bigger factor in keeping contracts enforced and stopping firms from committing fraud, because they reduce the potential for future exchange. Ed aims to write a book of case studies of this "private governance" phenomenon.

One example he used was of Jonathan's Coffeehouse, a private club that preceded the London Stock Exchange. In the 18th century, the government refused to enforce stock exchange contracts, seeing them as a form of gambling. Nevertheless, the Coffeehouse became a centre of commerce and contracts were usually upheld voluntarily. If you were a trader, you could rip somebody off once, but would be barred from the club. For people whose livelihoods were based on stock trading, it wasn't worth it.

The same phenomenon exists today in a whole range of exchanges. When I go to a restaurant and get a bland meal, it's practically certain that I won't sue. Does this mean that profit-maximising restaurants will constantly give out bland meals? No – if it serves bad food, I'll stop going and tell my friends not to go either. Reputational capital, so to speak, is enormously valuable, and losing it can be worse than just losing a court case. As a side-point, the reason that restaurants in touristy areas are usually so bad is down to this fact as well. Tourists typically don't know anything about the restuarants they go to – could things like TripAdvisor bring an end to tasteless, expensive tourist food?

Credit cards are another example of private governance. Dispute resolution is typically left to arbitration and mediation, without recourse to the courts. But there is a "shadow of the state" – it's possible that someone will bring an extreme case to the courts, which may make people more willing to comply with a mediation outcome. It strikes me that this might be the biggest problem with some examples of private governance – that people only acted well because they knew there was a slim chance of a very costly lawsuit – a sort of reverse moral hazard. This isn't always the case – certainly not in the stock market or restaurant examples – but it is a problem for others. The shadow of the state looms large.

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